DEPARTMENT OF STATE REVENUE

01-20181683.LOF

Letter of Findings: 01-20181683
Individual Income Tax
For the Year 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Married couple protested the determination that a payment pursuant to a promissory note constituted taxable income. After review of the documentation and analysis provided in the protest process, the Department confirmed that the payment was taxable income.

ISSUE

I. Individual Income Tax–Promissory Note.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-8.1-5-1; *Indiana Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 897 N.E.2d 289, 292 (Ind. Tax Ct. 2007); 45 IAC 3.1-1-1; *Blacks Law Dictionary* (10th ed. 2014).

Taxpayers protest the imposition of Indiana income tax on a payment made to them pursuant to a promissory note.

STATEMENT OF FACTS

Taxpayers ("Husband" and "Wife") are a married couple living in Indiana. In 2015, Taxpayers received a payment made under the terms of a promissory note. The Indiana Department of Revenue ("Department") determined that the payment constituted taxable income and issued a proposed assessment for Indiana adjusted gross income tax ("AGIT"), penalty, and interest. Taxpayers filed a protest, arguing that the payment was not taxable income in Indiana. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Individual Income Tax–Promissory Note.

DISCUSSION

Taxpayers protest the imposition of Indiana AGIT. Husband had been employed by a company that went out of business. As a result of the business closure, the business converted Husband's capital interest in the business into a series of promissory notes. Several years later, Husband was allowed by the Internal Revenue Service ("IRS") via an agreement ("Agreement") following an IRS examination, to claim as a loss the amount of partnership interest he held in the business. The Agreement also provided that if Husband subsequently received payment for any amount claimed as a loss, such a payment would be considered taxable income in the year it was received. In 2015, the business made a payment representing part of the amount claimed as a loss under the Agreement. The Department considered that payment to be income subject to Indiana AGIT. Taxpayers disagree with the Department's determination.

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the [D]epartment's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.,* 963 N.E. 2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue,* 897 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further,

"[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.,* 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

IC § 6-3-2-1(a) states:

> (a) Each taxable year, a tax at the following rate of adjusted gross income is imposed upon the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person:
> (1) For taxable years beginning before January 1, 2015, three and four-tenths percent (3.4[percent]).
> (2) For taxable years beginning after December 31, 2014, and before January 1, 2017, three and three-tenths percent (3.3[percent]).
> (3) For taxable years beginning after December 31, 2016, three and twenty-three hundredths percent (3.23[percent]).

IC § 6-3-1-3.5 provides:

> When used in this article, the term "adjusted gross income" shall mean the following:
> (a) *In the case of all individuals, "adjusted gross income" (as defined in Section 62 of the Internal Revenue Code)*, modified as follows:
> . . .
> (6) *Subtract any amounts included in federal adjusted gross income under Section 111 of the Internal Revenue Code as a recovery of items previously deducted as an itemized deduction from adjusted gross income*.

45 IAC 3.1-1-1 further describes adjusted gross income:

> Adjusted Gross Income for Individuals Defined. For individuals, "Adjusted Gross Income" is "Adjusted Gross Income" as defined in Internal Revenue Code § 62 modified as follows:
> (1) Begin with gross income as defined in section 61 of the Internal Revenue Code.
> (2) Subtract any deductions allowed by section 62 of the Internal Revenue Code.
> (3) Make all modifications required by IC 6-3-1-3.5(a).

Taxpayers protest that the Department misunderstands the nature of the payment they received. Taxpayers state that the payment was, in substance as well as legal form, a payment of a promissory note. Also, Taxpayers state that the only reason the payment was taxable for federal reasons was that the Agreement made it so. In effect, Taxpayers argue, they were repaying the IRS for a tax benefit taken under the terms of the Agreement. Additionally, Taxpayers state that they were not residents of Indiana in the year they took the federal tax benefit under the Agreement, therefore no corresponding Indiana tax benefit was ever taken.

Taxpayers also point to the Department's instructions for filing the IT-40 Indiana income tax return. Those instructions state that a taxpayer who recovers an itemized deduction which that taxpayer claimed in an earlier year should list such a recovery in the following manner:

> **Recovery of Deductions 616**
>
> You are not eligible for this deduction if you did not complete the "other income" line on your federal Form 1040.
>
> Generally, Indiana **does not** allow you to claim itemized deductions from federal Schedule A. However, if you reported recovered itemized deductions as "other income" on line 21 of your federal Form 1040, enter that amount on this line.
>
> A *recovery* is a return of an amount you deducted in an earlier year. The most common recoveries are refunds (see Schedule 2, line 3), reimbursements and rebates of deductions previously itemized on federal Schedule A.
>
> Enter code 616 on Schedule 2 under line 11 if claiming this deduction.
> (**Emphasis in original**)(*Emphasis in original*).

Taxpayers believe that the "616" code description in the IT-40 instructions is analogous to the payment they received. Taxpayers argue that a federal benefit taken in an earlier year is being repaid, but that no Indiana benefit was ever taken and therefore does not need to be repaid.

The Department does not agree with Taxpayers' conclusion. Specifically, IC § 6-3-1-3.5(a)(6) and the instructions for filing the IT-40 provide that a taxpayer should subtract any amounts included in federal adjusted gross income under Section 111 of the Internal Revenue Code as a recovery of items previously deducted as an itemized deduction from adjusted gross income. In the instant case, Taxpayers did not take the loss as an itemized deduction in the earlier year. Taxpayers have not referred to any statute, regulation, or court case which supports their position that non-itemized deductions may be subtracted from Indiana AGIT calculations.

Taxpayers also state that they were residents of another state in the year that the business went out of business and also in the year that they signed the Agreement with the IRS. This, Taxpayers believe, means that the benefit of taking the loss was never related to Indiana and so Indiana is now precluded from imposing AGIT on the payment. Taxpayers have not referred to any statute, regulation, or court case in support of their position that the fact that they did not live in Indiana during the year when they took the loss under the Agreement means that the payment was not subject to Indiana AGIT.

Next, Taxpayers argue that it is inherently inequitable to require them to treat the payment differently from its legal form of a promissory note payment. "Promissory Note" defined in *Blacks Law Dictionary* (10th ed. 2014) as:

> **1.** A written promise by one party (the *maker*) to pay money to another party (the *payee*) or to bearer. • A note is a two-party negotiable instrument, unlike a draft (which is a three-party instrument). – Also termed *promissory note.* Cf. DRAFT (1).
> . . .
> - **promissory note** (18c) An unconditional written promise, signed by the maker, to pay absolutely and in any event a certain sum of money either to, or to the order of, the bearer or a designated person. – Also termed *note of hand.*
> . . . .
> (**Emphasis in original**)(*Emphasis in original*).

Taxpayers believe that the fact that the payment flowed from a promissory note means that the payment was not income subject to Indiana AGIT. Taxpayers have not provided any additional analysis to explain why a payment resulting from a promissory note is not income subject to Indiana AGIT. As provided in the definition of "promissory note" above, it is in and of itself merely a promise from one party to pay money to another party. A payment made pursuant to a promissory note is not inherently a recovery of any nature, let alone a recovery of a previously claimed itemized deduction as required by IC § 6-3-1-3.5(a)(6). Taxpayers have not referred to any statute, regulation, or court case in support of their position that equity is a relevant factor in determining Indiana AGIT.

In conclusion, the Department is not convinced by Taxpayers' argument. The Agreement between Taxpayers and the IRS provides that any payment related to the promissory notes for which Taxpayers were allowed to claim losses would be considered taxable income in the year is was received. Under IC § 6-3-1-3.5(a), such an amount would be included in calculating Indiana AGIT. Taxpayers were residents of Indiana when they received the payment in 2015, therefore they received income which was properly included in their 2015 Indiana AGIT. The payment was not a recovery of an itemized deduction, as required by IC § 6-3-1-3.5(a)(6). Taxpayers have not referred to any statutes, regulations, or court cases which would support their position regarding equity.

FINDING

Taxpayer's protest is denied.

October 29, 2018.

Posted: 12/26/2018 by Legislative Services Agency
An html version of this document.